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Foreign Funds Spy Hidden Bounties in Indian Distressed Assets

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Want to buy an operating newsprint plant in India's Gujarat state with a capacity to produce up to 30,000 tons annually, and in excellent working condition? Or a cement plant in northern India with a capacity of a million tons annually, and with leased limestone reserves that can last 20 years? Perhaps a closed foundry or a vegetable oil plant might interest you. Sorry, the attractive sugar and textiles facilities are already taken.

Welcome to the biggest industrial garage sale in the emerging economies -- India's banks and institutional lenders are cleaning out their attics. The total face value of the country's distressed assets is estimated between $45 billion and $55 billion, and that pile is growing: The banking system alone unloaded an average of Rs. $22,000 crore ($5 billion) in non-performing assets in each of the past four years. Over the past year, a growing number of foreign hedge funds and private equity firms have been swarming India's financial markets, cherry picking underperforming assets with the potential to turn in big profits. These include some big names such as Citigroup, Standard Chartered, WL Ross and a Hong Kong-based distressed debt fund called ADM, and low-profile U.S.-based hedge funds such as Clearwater and Eight Capital.

Spring Cleaning after Many Years

India's banks and financial institutions are helping to create this market, having finally begun to rid themselves of the delinquent assets they have carried on their books for decades. To be sure, India's distressed assets market is in its nascent stages, and it's too early for war stories of success to drive growth. To gain increased momentum, a secondary market for these distressed assets has to evolve, and investors will need to see fewer restrictions on foreign funds. India Knowledge@Wharton spoke to key participants in the country's distressed assets market and faculty experts from Wharton, the Stern School of Business and London Business School, to visualize the road ahead.

The Indian government wants its financial system in order before a widespread crisis unfolds like the one that occurred across Southeast Asia in the late 1990s, or the U.S. thrift crisis of the 1980s. Policy utterances from India's finance ministry and its central bank in the past few years have found their way into legislation enabling securitization of distressed assets, and the creation of fast-track debt recovery tribunals and asset reconstruction companies, or ARCs. India's current economic boom is pushing its industries to peak capacity utilization, opening up huge opportunities for investors that can unlock unrealized value in distressed assets.

"The trigger is that banks are required to conform to Basel II standards (capital adequacy benchmarks specified by the Bank for International Settlements in Basel, Switzerland) and clean up their books," says Vinay Nair (http://www.wharton.upenn.edu/faculty/nair.html), Wharton professor of finance. He attributes the demand from foreign investors for India's distressed assets to liquidity that is "flush worldwide," adding that investors are encouraged by such positives as regulatory changes and the government "tending to favor such sales."

Big Capital Pursuing Greener Pastures

Edward Altman, professor finance at the New York University's Stern School of Business, says hedge funds and private equity funds in the U.S. are flush with cash after their "excellent performance" in the last three to four years. "But at the same time, the U.S. market has dried up to a great extent due to a benign credit environment in making funds available to all types of companies, including distressed companies ... and so these investors are looking to other pastures such as India." He notes that although China offers a bigger distressed assets market -- estimated at upwards of $500 billion -- "India has a highly sophisticated legal system that you could feel more comfortable understanding [while] hiring local people to help you."

On the supply side, Nair says that firms burdened with debt would find it painful to not be able to expand in an environment of robust economic growth. "Being in this kind of growth atmosphere and having a lot of inefficient debt makes the firms agreeable to restructuring deals," says Nair. The reverse is also true, if you ask Viral Acharya, a professor at London Business School who is also on the visiting faculty at the Indian School of Business. "Recent research in the credit markets has shown that bad things happen in pairs," he says. "Precisely at the time when the number of distressed securities goes up, the market for selling those assets becomes more illiquid." The takeaway from that, according to Acharya, is that it makes sense to form large trusts to invest in these assets because they can offset down cycles in one industry with assets in another industry that might be doing well.

Ravi Chachra, chief investment officer at a fund called Eight Capital in New York City, has a mandate from his institutional investors to deploy $150 million a year over the next three years in Indian assets, and he is prowling

India's distressed assets market. Eight Capital has already invested Rs. 125 crore ($28 million) in three deals featuring an auto parts company, a textile mill and a cement company. Two other deals are in the works. Chachra's preferred industries are paper, auto, textiles, cement and power.

Chachra says he is targeting a 35% internal rate of return annualized over three years, after which he plans to sell off those investments. His firm's deals have ranged from 28 to 78 cents on the dollar. In a typical case, he identifies a company with 30% to 40% capacity utilization in an industry where the leading company has 100% capacity utilization. Eight Capital infuses capital to ramp up production, and secures a couple of board seats to protect its investment. "In such cases, the embedded operating leverage is so huge that it will all start to drop to the bottom line," he says.

A Mega Aggregator of Distressed Assets

One of the busiest executives in India's distressed assets trade is S. Khasnobis, managing director and CEO of the Mumbai-based Asset Reconstruction Co. (India). Arcil, as it is called, was set up four years ago in the private sector by a handful of banks and financial institutions to unload their problem assets. Arcil is essentially an aggregator of distressed assets for other investors to buy and turn around. It currently has about 80 production facilities up for sale or open for additional investments, priced down to anywhere between 20 cents and 80 cents on the dollar, or their face values -- these include the newsprint plant and closed foundry mentioned earlier.

Khasnobis says some "60% to 70% of distressed assets can be restructured" back to productive shape. In resolving delinquent cases, Arcil takes over majority ownership (placed in a trust) but prefers working with the existing managements and requires them to bring in some additional capital. It then sets performance milestones and returns the ownership to the promoters who meet them. The other option, of course, is to sell the business and redistribute the proceeds to the original lenders. "In such cases, we show the Sarfesi Act (Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002) and use that as an enabler -- or a gun -- and tell the promoter that we don't think he can create value and [that we] have to sell out," says Khasnobis.

Arcil's performance so far seems to inspire confidence that its market is working. Until last year, it had acquired 622 bad loan cases from three dozen banks and institutional lenders valued at more than Rs. 22,000 crore (about $5 billion). It has since resolved more than 200 of those cases accounting for half the total value, and recovered Rs. 1,157 crore ($260 million) for the original lenders. Arcil itself made a $7 million post-tax profit last year.

Arcil doesn't pay cash for the distressed assets it buys; instead, it hands out promissory notes to the selling banks and institutions. Khasnobis backs his team of 50 staffers with assorted consultants to work with the original borrowers in restoring those assets to profitability, or sell them if necessary. That job done, Arcil shares the spoils with the lenders, keeping for itself a fifth of the money above a pre-specified level of returns. It is now planning a $750 million fund to tap newer opportunities.

Tracking the 'Bad Loan' Trail

India's banking system these days carries non-performing assets at just about 2% of loans -- a dramatic turnaround from levels of 15% to 20% in the 1980s and early 1990s. A career banker who worked with financial institutions before joining Arcil at its inception, Khasnobis recalls how bad loans accumulated at India's banks over the three decades before the 1990s. Public sector mindsets and one-size-fits-all lending templates meant that "application of mind was not required"; interest rates, promoters' contribution requirements and debt-equity ratios were fixed.

The prevailing "License Raj" dispensed permits to set up industrial capacities, unmindful of minimum economic sizes or scale, and internationally proven benchmarks. And many promoters in those days financed their contribution by inflating project costs, in effect converting borrowings into their equity. They also limited their risks by transferring their stakes to trusts from which they personally kept a distance but roped in family members as trustees.

Little was done -- or could be done -- in those days to discipline errant borrowers, although Khasnobis points out that many well-meaning promoters, too, became victims of external factors such as technology changes in their industries. In what was then a deficit economy, where even government agencies defaulted on their payment obligations (the public sector was the biggest buyer in many industries), recovery norms were not religiously enforced, and the legal system "was not conducive to taking action against defaulters," he adds. Lending institutions typically had no more than a couple of nominee directors on their borrower companies' boards, and government norms all but prevented them from taking equity positions on them. "The banks and financial institutions performed the role of venture capitalists, but they got the downside without the upside of the venture capital model," says Khasnobis.

Some inefficiencies of that old order persist, allowing investors chasing distressed assets to profit from them. "Banks look at the past, while investors look at the future," says Subodh Gupta, associate director at Motilal Oswal Investment Advisors, a Mumbai-based firm that advises both troubled companies and investors in distressed assets. He talks of how red tape stalled matters in a recent case where a public sector bank wanted to get rid of a delinquent loan it had made to an unidentified company in southern India. Gupta's client -- an investor fixated on the upside potential for the company -- made his proposal last September, but the bank took six months to sign off on the debt. "We knew the company would turn profitable," says Gupta. "Each quarter, as the company posted improved results, we worried that the bank would reverse the deal. But that didn't happen; it's not the bank's job to take bets on the future."

Regulatory Lubrication for Purging Delinquency

Non-performing loans at India's banks had reached alarming levels of more than 15% by the early 1990s. A 1992 piece of legislation made way for debt recovery tribunals for faster dispensation of delinquent cases. But was more time before policy makers took steps to create supporting institutional mechanisms. That came in 1997, when the government-appointed Narisimham Committee made the first serious attempt towards tackling non-performing assets at banks by recommending the creation of "asset recovery funds." The most important legislative move came a little over four years ago with the Sarfesi Act.

Nair recalls how the U.S. junk bond markets took off in the 1980s with a rash of deals, and says the Indian market, too, will see a lot of activity in the initial years. "After this phase, it just becomes a function of business cycles," he says. He expects the supply of distressed assets to stay at high levels in the next there years, but "ten years down the line, you won't have such an irony of a booming economy combined with [large] distressed asset investing opportunities."

Another limiting factor for foreign investors is the 49% cap on their investments, with sub-caps of 10% on individual investment entities. "The problem is that for these kinds of [distressed asset] deals, it becomes very important to have control," he says. "Until this control issue is sorted out, foreign investors will be very selective on the kind of deals they do."

Nair says the growth of India's distressed assets market "will be much stronger if you allow for a liquid junk bond market." Altman adds that foreign investors have to see demonstrable evidence that there are good profits to be made. He says liberalizing regulations to allow more foreign investors is vital because the increased competition would help owners of distressed assets get higher prices. "One way of getting people to come is to at least give the impression that high rates of return can be earned on these purchases," he says. "But at the same time, you must try to promote transparency so that the number of investors would increase."

Investors like Chachra are in a hurry and use their knowledge of the local markets as their information arbitrage opportunity. A veteran at the game, he has done deals in Latin America, in Korea during the Southeast Asian crisis of the 1990s and in the Philippines, besides the U.S. He shuns entire portfolios and prefers investing in single assets "because you know exactly what you are getting." The time window for the most attractive deals in India is quite small, he says. "The opportunity will be [gone] by next year; investors like me will eat it all up."

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